Contribution Income Statement

1️⃣ **Traditional Income Statement (Absorption Costing)**

- **Cost of Goods Sold (COGS)** includes both **variable and fixed production costs**.
- Expenses are grouped by **function** (e.g., production, selling, admin).
- Focuses on **net income** for external reporting.
- Fixed costs are **absorbed into inventory** and only expensed when sold.

Structure:

Code

Sales

− Cost of Goods Sold (variable + fixed)

= Gross Profit

− Operating Expenses

= Net Income

2️⃣ **Contribution Income Statement (Variable Costing)**

- Separates **variable costs** and **fixed costs** into distinct lines.
- Expenses are grouped by **behavior** (variable vs fixed), not function.
- Focuses on **contribution margin** and **segment performance**.
- Fixed production costs are **expensed in the period incurred**, not capitalized.

Structure:

Code

Sales

− Variable Costs (production + selling)

= Contribution Margin

− Fixed Costs (production + selling)

= Segment/Operating Income

🔍 **Why Use Contribution Format for Evaluation?**

- **Highlights controllable costs** for managers.
- Shows how much each segment contributes to covering fixed costs.
- Enables **multi-level performance analysis**:
    - **Level 1**: Contribution Margin
    - **Level 2**: Controllable Margin

- **Level 3**: Segment Margin
- **Level 4**: Operating Income (after common costs)

✅ **Key Differences Summary**

Feature	**Traditional Income Statement**	**Contribution Income Statement**
Costing Method	Absorption costing	Variable costing
COGS Includes	Variable + Fixed production costs	Only variable production costs
Fixed Costs Treatment	Capitalized, then expensed	Expensed immediately
Focus	Net income	Contribution margin & segment analysis
Use Case	External reporting (GAAP/IFRS)	Internal decision-making & control

2️⃣ **Key Structure:**

Item	**Explanation**
Sales Revenue	Total sales made by the segment or company
Less: Variable Costs	Includes variable production costs + variable selling & admin costs
= Contribution Margin (CM)	Revenue – all variable costs
Less: Fixed Costs	Includes all fixed costs (production and non-production)
= Operating Income	Final profit after fixed costs

3️⃣ **Contribution Margin:**

- Measures how much revenue is left to cover **fixed costs** and contribute to **profit**.
- Formula:

$$\text{Contribution Margin} = \text{Sales} - \text{Variable Costs}$$

4️⃣ **Evaluation Version (4-Level Format)**

Used to **evaluate managers and business units** by separating **controllable** and **non-controllable** costs:

Level	Type of Evaluation	Includes / Excludes	Purpose
Level 1	**Segment Manager's Performance**	Revenues – Variable Costs – Controllable Fixed Costs	Evaluates what manager can control
Level 2	**Segment Performance**	Revenues – Variable Costs – All Traceable Fixed Costs (controllable + non-controllable)	Evaluates the entire segment itself
Level 3	**Company Segment Reporting**	Add Common Fixed Costs (untraceable)	Evaluates total company performance
Level 4	**Company Overall Performance**	After all costs (including untraceable common costs)	For top management

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5️⃣ **Definitions:**

- **Controllable Costs** → Costs the segment manager can influence (e.g., labor, advertising).
- **Non-Controllable Costs** → Costs the manager **cannot** influence (e.g., corporate overhead).
- **Traceable Fixed Costs** → Fixed costs **directly linked** to a segment and would disappear if that segment closed.
- **Untraceable (Common) Fixed Costs** → Costs **shared** among segments; they would remain even if a segment is closed.

6️⃣ **Purpose:**

✅ Helps evaluate:

- **Managers** → Based on costs they can control.
- **Segments** → Based on performance independent of shared corporate costs.

✅ Improves:

- **Decision-making** about which segments are profitable.
- **Fair performance measurement** by separating controllable vs. non-controllable costs.

🧻 **Four Levels of the Contribution Income Statement for Evaluation**

🔹 **Level 1: Manufacturing Contribution Margin**

Formula:

$$\text{Manufacturing Contribution Margin} = \text{Net Revenues} - \text{Variable Manufacturing Costs}$$

Includes:

- **Net revenues** → Total sales for the period.
- **Variable manufacturing costs** → Direct materials, direct labor, and variable factory overhead (costs related to production).

Meaning:

- Shows how much is left after covering **variable manufacturing costs**.
- This margin must cover:
    - Variable nonmanufacturing costs,
    - All fixed costs, and then
    - Flow to **profit**.

Key point:
Increases in this margin directly increase profit once all other costs are covered.

🔹 **Level 2: Contribution Margin**

Formula:

$$\text{Contribution Margin} = \text{Manufacturing Contribution Margin} - \text{Variable Nonmanufacturing Costs}$$

Includes:

- **Variable nonmanufacturing costs** → Marketing, selling, administrative expenses that vary with sales.

Meaning:

- Represents the **amount available to cover fixed costs** (both controllable and non-controllable).
- After all variable costs (manufacturing + nonmanufacturing) are covered, the remaining contribution margin contributes to profit.

🔹 **Level 3: Controllable Margin**

Formula:

$$\text{Controllable Margin} = \text{Contribution Margin} - \text{Controllable Fixed Costs}$$

Includes:

- **Controllable fixed costs** → Fixed expenses the segment manager can influence, such as:
    - Department-level supervisor salaries

- Advertising or promotion specific to that segment

Meaning:

- Measures **manager's short-term performance** (usually < 1 year).
- Only includes revenues and costs that the **manager controls** directly.

Also called: *Short-term segment manager performance.*

🔹 **Level 4: Segment Margin**

Formula:

$$\text{Segment Margin} = \text{Controllable Margin} - \text{Non-controllable, Traceable Fixed Costs}$$

Includes:

- **Non-controllable, traceable fixed costs** → Fixed costs tied to the segment but **not controlled** by the manager in the short term (e.g., depreciation, property tax, insurance).
- These costs **would disappear** if the segment were sold or closed.

Meaning:

- Measures **segment (business unit)** performance.
- Sometimes used as a measure of the manager's **long-term performance**, if they influence traceable fixed costs over time.

Also called: *Contribution by Strategic Business Unit (SBU).*

🚫 **Untraceable (Common) Fixed Costs**

- **Untraceable/common costs** = Corporate-level expenses not linked to any one segment.
  - Example: CEO salary, HQ rent, corporate advertising.
- These **continue** even if a segment is shut down.
- **Not used** in evaluating segment or manager performance, because they are **not controllable**.

Important Note:

- Because these costs are omitted from segment reports,
  the **sum of all segment profits ≠ total company profit**.
- Example:
  - Total of segment margins = $2,250
  - Company net income = $1,250
  - Difference = $1,000 → Untraceable common fixed costs

Differences Between Controllable vs Traceable Fixed Costs

- **Controllable Fixed Costs** = What the manager can **actively manage** (e.g., promotions, team salaries).
- **Traceable Fixed Costs** = What the segment **must bear**, but the manager **can't control directly** (e.g., depreciation on segment-owned equipment).

✅ **Summary Table**

Level	Name	Formula / Components	Purpose
1	Manufacturing Contribution Margin	Revenues − Variable Manufacturing Costs	Covers all nonmanufacturing and fixed costs
2	Contribution Margin	Level 1 − Variable Nonmanufacturing Costs	Covers all fixed costs
3	Controllable Margin	Level 2 − Controllable Fixed Costs	Evaluates manager's short-term performance
4	Segment Margin	Level 3 − Non-controllable, Traceable Fixed Costs	Evaluates segment's long-term performance

📘 **Use of the Contribution Income Statement**

🔹 1️⃣ **Purpose and Flexibility**

A **Contribution Income Statement** is highly **versatile** — it can be used for:

Purpose	Explanation
Manager Performance Evaluation	Measures how well a manager controls revenues and controllable costs.
Segment (Profit or Investment Center) Evaluation	Measures how profitable a division or business unit is overall.
Decision-Making Tool	Helps determine whether to **drop**, **retain**, or **expand** a segment or product line.
Product Profitability Analysis	Assigns segment revenues and costs to specific products to identify which products contribute most to company profit.

🔹 2️⃣ **Segment Margin and Its Role**

- **Segment Margin** = Segment's **total sales – all variable and fixed costs** that are **traceable** to that segment (both controllable and non-controllable).
- It represents the **true profitability** of each business segment.

✅ **Used for:**
Evaluating the **segment's overall performance** (not the manager's).

🚫 **Not included in segment margin:**

- **Untraceable (common) fixed costs**, because:
    - They cannot be tied to any single segment.
    - They are **not controllable** by the segment manager.

🔹 3️⃣ **Examples of Untraceable, Common Costs**

Example	Why Not Traceable?
CEO's Compensation	The CEO manages the whole company; time can't be divided accurately among segments.
Corporate Sponsorship (e.g., World Cup, Olympics)	Benefits all divisions collectively; hard to measure impact per segment.
Corporate Headquarters Rent or Utilities	Shared resource across divisions.

💡 **Key point:**
Even if the accounting system allocates these costs for reporting, **they must be excluded** from **segment performance reports** used for evaluation — so that managers aren't held responsible for costs **outside their control**.

🔹 4️⃣ **Managerial and Strategic Use**

- Helps identify:
    - Which **products or divisions** contribute to **covering common costs**.
    - Which are **underperforming** and may be candidates for elimination.
- Supports decisions like:
    - Expanding profitable lines.
    - Reducing unprofitable operations.
    - Focusing on products that generate **high contribution margins**.

💰 6️⃣ **Profit Margin Ratio**

Definition:
Measures how much of sales revenue becomes **profit (net income)**.

$$\text{Profit Margin Ratio} = \frac{\text{Net Income}}{\text{Sales (Revenue)}} \times 100$$

Interpretation:

- A **higher ratio** = More profit per rupee of sales.
- Shows the **overall efficiency** of converting sales into profit.

Ways to improve profit margin:

1. **Increase sales** while holding costs constant.
2. **Reduce costs** without losing sales.
3. **Increase sales faster** than costs increase.

✅ **Summary Overview**

Aspect	Explanation
Main Use	Evaluate managers, segments, and products.
Key Exclusion	Non-controllable, untraceable common costs (e.g., CEO salary).
Decision Use	Drop, retain, or expand segments or products.
Exam Focus	Be able to calculate all 4 margins + profit margin ratio.
Profit Margin Ratio	Net Income ÷ Sales— measures profitability efficiency.